Public finances: the consolidation so far, and a dicey decade ahead?

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Underlying weakness in the public finances and the fiscal response

Yellow line shows the estimated underlying increase in structural borrowing since March 2008.

Notes and sources: see Figures 1.3 to 1.6 of The IFS Green Budget: February 2015.
The December 2014 plan: up to 2014–15

• £110bn of fiscal tightening measures implemented
  – 82% from spending cuts and 18% from net tax rises
• £27bn more than planned in Labour’s March 2010 Budget
  – roughly the same magnitude of net tax rise
  – £15bn greater social security cuts
  – £18bn of additional cuts to other day-to-day public spending
  – £6bn smaller cut to investment spending
The December 2014 plan: beyond 2014–15

- £92bn of further fiscal tightening to come
  - so on this measure 55% done 45% to do
- Most to come from cutting day-to-day public spending
  - small net tax rise and small cut to investment spending relative to pre-crisis baseline (latter still less than that implied by March 2010 Budget)
  - £6bn of further social security cuts from measures already place
  - £81bn of further cuts from day-to-day public spending as a share of national income to be found
  - 98% from spending cuts and 2% from net tax rises
- Overall the plan from 2010–11 to 2019–20 comprises 89% spending cuts and 11% net tax rises
The December 2014 plan: international comparison

• Comparison of IMF forecasts for structural borrowing in 32 advanced economies shows that the UK is forecast to have:
  – the 4\textsuperscript{th} largest structural borrowing at the peak during the crisis
  – implemented the 7\textsuperscript{th} largest consolidation up to 2015
  – (essentially) the 2\textsuperscript{nd} largest structural borrowing in 2015
  – the largest planned fiscal consolidation between 2015 and 2019
  – the 18\textsuperscript{th} largest (or 15\textsuperscript{th} smallest) structural deficit in 2019
Successive forecasts for borrowing

% of national income

Financial year


Budget, March 2008
Budget, March 2010
Autumn Statement, November 2010
Autumn Statement, December 2012
Autumn Statement, December 2014

Deficit in 2014–15:
half 2009–10 level
but 2.6 times Nov 2010 forecast

Notes and sources: see Figure 1.1b of The IFS Green Budget: February 2015.
Public sector debt high by recent historical standards

Notes and sources: see Figure 5.2 of *The IFS Green Budget: February 2015*.
Public sector debt high by recent historical standards

Debt hasn’t exceeded 80% of national income since 1967–68

But was higher from:
1830–31 to 1869–70
1916–17 to 1967–68

Notes and sources: see Figure 5.2 of The IFS Green Budget: February 2015.
Public sector debt high by recent historical standards

1ppt increase in interest rates would add £5.3bn per year to the debt interest bill

Notes and sources: see Figure 5.2 of The IFS Green Budget: February 2015.
Debt: the parties’ plans

• Three main UK parties have fiscal rules which require debt to fall as a share of national income
• If throughout 2020s you achieve:
  – 1% of national income budget surplus: debt/GDP 27 percentage points (ppts) lower
  – balanced budget: 19ppts lower
  – balanced current budget, maintain investment spending: 9ppts lower
Forecasts for receipts and spending

Plans imply public spending to be cut to lowest level since at least 1948

Notes and sources: see Figure 5.1 of *The IFS Green Budget: February 2015*. 

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How large a fiscal consolidation is required?

Estimated fiscal tightening beyond 2014–15 to achieve structural:

- **current budget balance**: 2.6%
- **overall budget balance**: 1.2%
- **1.1% of national income surplus**: 1.1%

**OBR (−0.6% output gap)**:
- 4.9% of national income tightening planned

Notes and sources: see Table 5.2 of *The IFS Green Budget: February 2015.*
How large a fiscal consolidation is required?

Estimated fiscal tightening beyond 2014–15 to achieve structural:

- OBR (−0.6% output gap):
  - Current budget balance: 2.6%
  - Overall budget balance: 1.2%
  - 1.1% of national income surplus

- Pessimistic (+1.9% output gap):
  - Current budget balance: 4.5%
  - Overall budget balance: 1.2%
  - 1.1% of national income surplus

Notes and sources: see Table 5.2 of The IFS Green Budget: February 2015.
How large a fiscal consolidation is required?

Estimated fiscal tightening beyond 2014–15 to achieve structural:

- **Optimistic** (-4.2% output gap): 1.1% of national income surplus
- **OBR** (-0.6% output gap): 1.1% of national income tightening
- **Pessimistic** (+1.9% output gap): 4.9% of national income tightening planned

Notes and sources: see Table 5.2 of The IFS Green Budget: February 2015.
Cutting spending and keeping it down difficult

• Implied cuts are large
  – 2009–10 to 2014–15 already represents longest and deepest period of consecutive cuts to public service spending per head since WW2

• Additional pressures in next parliament
  – easiest cuts presumably done first
  – public sector wage restraint harder when private sector wages rising
  – public service pensions to cost public sector employers £4.7 billion per year more due to recent revaluation and increased employer NICs

• Longer-term pressure: ageing population
  – even with optimistic assumptions over health spending, projected to add 3.9% of national income to spending over next fifty years

• New “welfare cap” could reduce unanticipated increases in social security spending
Risks in forecasts for receipts

• Three risks to revenue forecasts
  – growth will differ from the forecast
  – composition of growth will differ from the forecast
  – policy will be changed
Composition of growth will differ from the forecast

- Receipts of income tax and NICs affected by the composition as well as the level of aggregate employment income
- Recent years have demonstrated this
  - Aggregate employment income growth, 2009–10 to 2015–16,
    - June 2010: 29.1%
    - December 2014: 21.1%
    - Receipts £26.2bn lower because of lower aggregate employment income
    - In addition, different composition of growth (more employment, lower earnings) reduced revenues by further £6.5bn
- Recent reforms have slightly increased sensitivity of revenues to how growth is distributed
  - Income tax has been made more progressive
  - Increased reliance on capital taxes
Policy risk: upside risk for revenues

- General elections
  - with notable exception of spring 1992, pre-election budgets appear relatively restrained
Policy risk: downside risks risk for revenues

- Forecasts assume rates of fuel duties indexed in line with the (discredited) RPI
  - recent history suggests this won’t happen: 5-year cash freeze would cost £4.1bn in 2019–20, CPI-indexation would cost £1.8bn
- Income tax personal allowance and higher-rate threshold CPI uprated
  - we estimate 5.1 million higher-rate taxpayers in 2015–16, fiscal drag increases this by 1.2 million in 2020–21 and by 2.8 million in 2025–26
- Some thresholds frozen in cash terms
  - £100k and £150k income tax thresholds
  - £50k and £60k child benefit takeaway thresholds:
    • we estimate 1.2m families lose some/all child benefit in 2015–16
    • fiscal drag would result in 50% increase by 2020–21
    • and a more than doubling by 2025–26
Summary (1/2)

- Much fiscal tightening done, plans imply almost as much to do
  - £110bn of fiscal tightening measures implemented; 82% from spending cuts and 18% from net tax rises
  - plan implies £92bn of further fiscal tightening to come; 98% from spending cuts and 2% from net tax rises
- Additional tightening due to downgrade in borrowing forecasts between 2010 and 2012 and Chancellor’s desire for budget surplus
- Debt high by recent historical standards
  - explains desire from all three main UK parties to ensure it falls, albeit at different speeds
  - balanced budget would reduce debt by 19% of national income after ten years compared to a 9ppt fall from a balanced current budget
Summary (2/2)

• The amount of spare capacity in the economy is one key risk
  – could be much less – or more – need for austerity if a budget surplus is to be brought about

• Deep spending cuts are another risk
  – can spending plans be delivered, and if so could spending be held down to such historically low levels?

• Revenues have disappointed in this parliament and could do again
  – strong employment growth coupled with very weak earnings growth has been bad for tax receipts

• Future policies will also affect revenues
  – will RPI indexation of fuel duties actually happen?
  – will more individuals face higher and additional rates of income tax?
  – will more and more families have their child benefit withdrawn?
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